TAXATION OF CAPITAL IN VIRGINIA.

AMONG the interesting and perplexing tax questions which have become highly practical to manufacturers and their advisers on account of the recent activity on the part of examiners of records and local boards of review in Virginia, are several that have arisen under those portions of the Revenue Act which provide for the assessment and taxation of capital. The second, third and fourth sub-sections of Section 8 (Schedule C—Intangibles) of the Tax Bill, deal specifically with the assessment of "capital;" while the first sub-section of that section, although not dealing with capital, has a bearing which is important, as will hereafter be observed. The following extract from Section 8, in its present amended form, is sufficient for the purpose of this discussion: [1]

'Section 8. The classification" (of taxable subjects) "under Schedule 'C,' shall be as follows:

"First. Bonds, notes and other evidences of debt, including bonds * * * and all demands and claims, however evidenced * * *.

"The commissioner shall require each person * * * to make out and deliver to said commissioner a list * * *.

"* * * The said list and statement shall include bonds * * * and all demands and claims * * * , *deducting from the aggregate amount thereof all such bonds, demands or claims not otherwise deducted, owing to others as such principal debtor,* * * *.

"Second. All capital of individuals * * * in business out of this state.

"Third. All capital of corporations * * * not otherwise taxed * * *.

"Fourth. All capital of individuals invested, used or employed in any trade or business not otherwise taxed. Moneys and credits *actively used and employed* in carrying on the trade or business, materials, goods, wares and merchandise on hand, and all solvent bonds, notes, demands or

[1] Virginia Acts of Assembly, 1915, c. 70, § 8, p. 98.

> claims made or contracted in the course of business during the preceding year (but not including any *moneys on hand* received from loans made for a period of not more than four months, which shall be owing and shall have been actually contracted for the necessary conduct of such business), shall be held to be capital in such trade or business, and shall *not be taxed otherwise* than as such capital; but real estate shall not be listed as such capital, but shall be listed and taxed as real estate; * * *."

It will be observed that this classification is by no means logical. It would seem, for instance, that the contents of the second sub-section are in reality embraced in the comprehensive terms of the fourth sub-section. And the attempted definition of capital—if definition it can be called—contained in the fourth sub-section, has, because of the peculiarity of its phraseology, given rise to great diversity of opinion among lawyers and taxing officials as to its true meaning. It will be noticed that while the subject of the tax is "capital"—a thing altogether intangible, and constantly changing and shifting—the definition, if taken literally, embraces things altogether tangible; and it will be further noticed that a number of the intangible elements subsequently mentioned in the definition are apparently covered by the broader term "credits" also used therein. As this statutory provision stood in former Revenue Acts—e. g., the Act of 1890—the confusion of words was even greater than at present, since it was there provided that "moneys and credits * * * *including* goods, wares and merchandise, * * * shall be held to be capital." [2] This identical confusion still persists in a similar definition contained in that portion of the present Revenue Act relating to merchants' licenses. [3] How it is possible for intangible credits to *include* tangible merchandise passes the human understanding. The conclusion is irresistible that the definition was the work of some careless draughtsman, and that its true meaning can not possibly be gathered except by subordinating its wording to the inherent meaning of capital itself.

By reason of the language used in this definition of capital, and of the absence from the sub-sections dealing with capital of

[2] Virginia Acts of Assembly, 1889-90, c. 244, § 8, p. 201.

[3] Virginia Acts of Assembly, 1915, c. 148, § 46, p. 233.

words in terms giving a right to deduct certain liabilities, such as are contained in the first sub-section, some of the taxing officials contend, and it is understood that the Auditor of Public Accounts has ruled, that a manufacturer, in making a calculation in order to determine the amount of his capital as of the first day of February, has no right to make any deduction whatever, from the aggregate of his bills and accounts receivable, of the amount of, or in fact any of, his bills and accounts payable.

A specific illustration will clarify the point: X, having sufficient means, decides to embark in the business of manufacturing flour. After buying a plant equipped with the necessary machinery, all of which is properly taxed as real estate, he has left the sum of $10,000.00 in money to use as his working capital. If his capital should be assessed at this stage of the business, no one would doubt that the amount assessable would be $10,000.00. By reason of his good reputation and the ready cash mentioned, he quickly purchases, manufactures and sells a large amount of goods. At a later date, in making a calculation to ascertain his capital, he finds that, outside of his real estate, he has bills and accounts receivable amounting to $100,000.00, with bills and accounts payable amounting to $90,000.00, the difference being exactly equal to his original $10,000.00. Hardly any man of business would deny that at this stage, as at the former period, the actual capital of the manufacturer would not exceed $10,000.00.

That it is usual and necessary, in order to ascertain capital, to deduct such items, appears to have been recognized by Judge Keith at the time of the decision of the case of Allen *v.* Commonwealth, [4] in which, referring to two companies, he said that "the amount of their *capital* is ascertained by taking the aggregate value of all of the personal property of the company, wherever situated, including money, credits and investments, whether in or out of the state, *deducting* from said money, credits and investments *what they owe to others as principal debtors.*" But now the contention and ruling, as above mentioned, is that X, in the illustration stated, must pay taxes upon a capital of $100,000.00. It is believed that this view is based upon

[4] 98 Va. 80, 81, 34 S. E. 981.

a misapprehension of the statute and of a misconception of the precise question that was decided in the case which is cited in support of it. [5]

There is a wide difference between "capital" on the one hand, and property or assets on the other. As said by the Virginia Court in the Bridgewater case, "* * * the word 'capital,' when used in reference to commerce or trade, including manufacturing, signifies the money and other property *adventured in the business.*" As put by another authority, "capital is the sum which a merchant, trader or other person or association adventures in any business requiring the expenditure of money with a view to profit." In the case of Clark *v.* Bailey, [6] it is said that "when the debts of a co-partnership are paid, what remains is capital, or capital and profits, as the case may be." In brief, capital (whether the thing composing it should have been previously inherited, earned or borrowed) is the intangible fund which is the *basis* of the business; its form, and the things into which it happens to be enveloped from day to day, are constantly shifting and varying; but a calculation involving indebtedness, as well as assets, is, at any given time, *inherently necessary* to determine its amount. As said by Justice Peckham in People *v.* Barker, [7] "this indebtedness must, *in the nature of things* be taken into consideration in arriving at the value of the capital * * *."

It has been observed that in the first sub-section of Section 8, the taxpayer is allowed to deduct from the aggregate amount of the items therein mentioned "all such bonds, demands or claims not otherwise deducted, owing to others * * *." It is said that if the legislature had intended to permit the deduction of accounts payable from accounts receivable, in calculating capital under the other sub-sections, it would have so provided in express terms. This, however, by no means follows. In the first sub-section, the things taxed were specific items of intangible property, while the deductions allowed therein were of other distinct specific items; in the following sub-sections referred to,

[5] See Bridgewater Mfg. Co. *v.* Funkhouser, 115 Va. 476, 79 S. E. 1074.
[6] 12 Blatch. 156, 158, 5 Fed. Cas. 856, 857.
[7] 139 N. Y. 55, 63, 34 N. E. 722, 724.

the thing taxed is *capital,* and in order to ascertain the extent of that thing, a calculation involving a deduction of bills and accounts payable is, "in the nature of things," necessary. Hence, there was no need whatever of giving in express terms, in those sub-sections, a right of deduction. It will not do to take the crude definition of capital too literally, since to do so would be to get entirely away from the inherent meaning of the thing that is taxed—capital. That meaning must be borne in mind and given effect no less than the illogical definition. It will be noticed, furthermore, that while in the attempted definition it is said that the items specified "shall be held to be capital," it is by no means said in express affirmative terms that they *shall be* taxed as if they were independent items, regardless of liabilities, while it is, on the other hand, expressly provided in negative terms that they *"shall not be* taxed otherwise than as such capital."

The evolution of this statutory definition of capital is not without interest. That portion contained in parentheses followed the Bridgewater decision, [8] and appeared for the first time in the amendment of 1915. Apart from this, a similar, but not identical, definition was contained in the previous Revenue Acts of 1876, [9] 1884, [10] and 1890, [11] although it is significant that the last mentioned act contained, at the end of the definition, these words, which are omitted from the present act: "but nothing herein shall be held to exclude from taxation any property which is the subject of such business." [12] The Revenue Act if 1867 [13] was less similar and was itself an amendment of Chapter 35 of the Code of 1860. In the corresponding section of that Code it is provided that the commissioner shall ascertain "the capital invested, used or employed in any manufacturing or mining business * * * not including therein the assessed value of their estate and the value of their slaves, which shall be listed and assessed as in other cases; but in neither of the cases men-

[8] *Supra.*
[9] Virginia Acts of Assembly, 1875-76, c. 162, § 8, p. 164.
[10] Virginia Acts of Assembly, 1884-85, c. 450, § 8, p. 564.
[11] Virginia Acts of Assembly, 1889-90, c. 244, § 8, p. 201.
[12] Id.
[13] Virginia Acts of Assembly, 1866-67, c. 298, p. 727.

tioned shall the personal property, except slaves, credits and monies, used, acquired or held in such trade or business, *be otherwise assessed or listed than as such capital.*" [14]

To say that all the accounts receivable, in gross, which a manufacturer has on his books are a part of his capital, regardless of the fact that the accounts payable by him may nearly or quite equal in amount those accounts receivable, is a confusion of terms. In the illustration given above it is clear that if the manufacturer should have the good fortune, during the latter part of January, to collect all his accounts, and at once disburse the amount needed to settle his bills and accounts payable, he would then have a taxable capital of not exceeding $10,000.00; but to affirm that, if these collections and consequent disbursements were not made until after the first of February, he would have a taxable *capital* ten times as great, shocks the mind. To slightly paraphrase a statement quoted by the Supreme Court of the United States in the case of Bailey *v.* Clark.[15] "It would not satisfy the demands of common honesty if a man engaged in business of any kind, being asked the amount of capital employed in his business, should include in his reply all the sums which in the conduct of his business were due him regardless of the sums due by him to others." Certainly it cannot be said that these accounts receivable, taken in gross, constitute "credits *actively used and employed in carrying on the trade or business.*" They are not used or employed in this sense at all, but the fact is simply that into these accounts the actual capital happens, for the time being, to be absorbed and enveloped. In this connection, a decision of the Nebraska Court, referred to later, wherein the word "credits" was held to mean, not gross credits, but net credits, is illuminating.

Bridgewater Mfg. Co. *v.* Funkhouser.

Reference has been made above to the case of Bridgewater Manufacturing Company *v.* Funkhouser.[16] It is very important to bear in mind precisely what was decided in that case. The proceeding was one to have corrected an alleged erroneous as-

[14] Code of Virginia (1860), c. 35, § 55.
[15] 21 Wall. (U. S.) 284.
[16] *Supra.*

sessment. The testimony showed "that the total *running capital* of the company invested in its business * * * was $16,703.00; that *of this sum* $14,000.00 was *borrowed money;* * * *" The complainant contended that the capital taxed was "the *original* capital paid in by the share-holders, less the amount invested in real estate and *the money borrowed by the company to be used in conducting its business.*" The court very properly said that that contention could not be sustained, and that the "capital stock of the company must be clearly distinguished from the amount of capital invested in its business or the amount of property possessed by it;" and that there was at that time "no warrant in the statutes for the contention that, in arriving at the subject of taxation, the complainant is only liable for taxes upon the net balance *of capital* after deducting *the money borrowed by the company to be employed in conducting its business.*" The court, quoting the Circuit Judge, said that "it can make no difference whether the *capital,* or part of it, is borrowed or not. It is none the less capital of the user, and employed for his profit and at his risk." The court referred to the fact that "large business enterprises are often carried on chiefly, and sometimes wholly, with a borrowed working capital, and if this indebtedness, whether temporary or permanent, is to be deducted in ascertaining the capital for taxation, such enterprises would escape their just share of the burdens of government." The argument in the Bridgewater opinion must be read in connection with the precise point that was being decided. That point is utterly different from the proposition that, in making a calculation necessary to ascertain his capital, a manufacturer has no right to deduct the amount of his accounts payable from the amount of his accounts receivable. In the Bridgewater case, the effort was made to deduct borrowed *capital* from what was stated as being the "total running *capital* of the Company." It is one thing to deduct a part of the capital from the aggregate capital, and an entirely different thing to deduct the amount of bills payable from the amount of bills receivable in order to ascertain what is capital.

In connection with the Bridgewater decision,[17] and with the

[17] *Supra.*

words in parentheses contained in the Virginia statute as quoted above, the case of Bailey, Collector, *v.* Clark,[18] decided by the Supreme Court of the United States some years ago, is very interesting. The Federal Revenue Act had provided, among other things, for a tax "upon the capital * * * employed by any person in the business of banking * * *." Clark and his associates, New York bankers, made returns to the assessor of the amount of their fixed capital employed in banking, and of the amount of money deposited with them by their customers. The assessor insisted that all moneys borrowed by the bankers from time to time, and temporarily in the ordinary course of their business, formed a part of their capital employed in the business of banking, and were subject to the tax, and accordingly assessed the tax upon the amounts thus borrowed as a part of their capital. Mr. Justice Field, in delivering the opinion of the court, said that the term *capital* in the Revenue Act was "not there used in any technical sense, but in its natural and ordinary signification * * *. When used with respect to the property of a corporation or association the term has a settled meaning; it applies only to the property or means contributed by the stockholders as the fund or basis for the business or enterprise for which the corporation or association was formed. As to them the term does not embrace temporary loans, though the moneys borrowed be directly appropriated in their business or undertakings. And when used with respect to the property of individuals in any particular business, the term has substantially the same import; it then means the property taken from other investments or uses and set apart for and invested in the special business, and in the increase, proceeds or earnings of which property beyond expenditures incurred in its use, consist the profits made in the business. It does not, any more than when used with respect to corporations, embrace temporary loans made in the regular course of business."[19] The court said that it was "undoubtedly true, as stated by the Attorney General, that capital used in the business of banking is none the less so because it is borrowed. The mere fact that the money permanently invested in the business is borrowed does not alter

[18] *Supra.*

[19] 21 Wall. (U. S.) 284, 286.

its character as capital. The question here is whether money not thus permanently invested, but borrowed temporarily in the ordinary course of business to meet an emergency, is capital; and we are clear that the term does not, either in common acceptation or within the meaning of the statute, embrace loans of that character." [20]

Two New York decisions may also be consulted with profit in this connection. In People *v.* Barker,[21] where the subject of the assessment was the capital of the Edison Electric Illuminating Company, Peckham, J., said:

> "* * * Outside of its patents the total gross assets of the relator, as above stated, included all its capital. These gross assets, it is thus seen, did not equal the amount of its indebtedness ($2,690,503.00), saying nothing of the deduction to be made on account of the assessed value of its real estate ($698,500.00). This indebtedness must, in the nature of things, be taken into consideration in arriving at the value of the capital of the relator * * *."

In People *v.* Roberts [22]—a proceeding to review an assessment—Putnam, J., said:

> "I am unable to understand on what ground the comptroller, in determining the amount of corporate stock employed in this state, excluded from considerations the debts and liabilities of the relator. The affidavit * * * showed that the value of the gross assets of the corporation in this state and Connecticut was $305,445.09, and that its debts and liabilities * * * were $189,343.00, leaving the net assets $116,102.09 from which should be deducted $18,102.00, capital employed in Connecticut, leaving a balance employed in this state $98,000.09. * * * It will not be doubted that in estimating the amount of capital stock employed in the state by a corporation under the provisions of section 11 * * * the debts and liabilities of a corporation must be taken into account. The actual amount employed is the net amount. * * * The amount of the capital stock employed in this state by a corporation under the provisions of the act in question, must be deemed the actual value of

[20] 21 Wall. (U. S.) 284, 288.
[21] 139 N. Y. 55, 63, 34 N. E. 722, 724.
[22] 19 App. Div. 574, 575, 46 N. Y. Supp. 570, 571.

such property; that is the gross value, deducting the amount of its debts and liabilities."

In the Nebraska case of Lancaster County *v.* McDanold,[23] the statute had provided for the assessment of "all moneys, credits, bonds or stock, * * * moneys loaned or invested * * * and all other personal property." The court said:[24]

"If by the term 'credits' in this schedule, the Legislature intended the thing defined as 'credit' in section 10,404—'every demand for money, labor or other valuable thing, whether due or to become due'—and it was intended that gross credits should be taxed, it would certainly have been wholly unnecessary to have included also 'moneys loaned or invested.' If we consider that the Legislature intended to classify credits, then the purpose of this provision in regard to the schedule becomes apparent. It is suggested * * * that merchants might be largely indebted for stock carried by them, and at the same time have credits due them from customers for amounts approximately the value of their stock. Goods bought upon credit might also be sold upon credit, and the amount of such credits held by the merchant might largely exceed the moneyed capital of his business. It seems reasonable that the Legislature should have intended to allow such credits and debts to offset each other, and at the same time to require that money that was loaned or invested as a speculation should be taxed, without the right of deducting the general indebtedness of the taxpayer.

"* * * The conclusion is that the Legislature intended that moneys loaned or *invested* shall be taxed without deduction on account of indebtedness, and the 'credits' that are to be taxed are the true credits. The taxable credits of an individual or business is the amount that can be realized upon an adjustment of accounts. To determine the real credits of a business, account must be taken of its liabilities. * * *"

The policy of Virginia, as was said by our Court of Appeals in Morris & Co. *v.* Commonwealth,[25] "is to encourage manufacturers within its limits, induce them to come into Virginia

[23] 73 Neb. 453, 103 N. W. 78.
[24] 73 Neb. 453, 455, 103 N. W. 78, 79.
[25] 116 Va. 912, 917, 83 S. E. 408, 410.

and establish their plants and thereby contribute to the general prosperity of the state." In these modern times very little business is done on a strictly cash basis, and this fact needs to be borne in mind in the interpretation, no less than in the enactment, of tax statutes. If the ruling of the Auditor referred to above is correct, this is one of the striking inequalities that of necessity results: Z, who has retired from business and who, perhaps, is producing nothing for the community, is the owner of notes aggregating $30,000.00, while he is the maker of outstanding notes aggregating $20,000.00. Clearly, under the first sub-section of Schedule C, he can deduct the latter items from the former, paying taxes only on the net difference of $10,000.00; while X, the active manufacturer, who has on his books notes receivable aggregating $30,000.00, with notes payable aggregating $20,000.00, cannot, according to the contention, deduct any of the latter from the former, but must pay taxes at the identical rate upon the whole $30,000.00. This injustice should not be, and if the statutory definition of capital, correctly interpreted, leads to any such result, it should be radically recast and amended at the earliest opportunity.

Many other questions, of practical importance, arise out of the statute which we have been considering, one being the proper method of arriving at "fair *market value*" as applied to capital; and another being the construction which the Virginia court will finally place upon the bracketed words in the fourth sub-section, *ante,* that is, whether the deduction therein expressly allowed can only be made when the borrowed moneys, as such, are still on hand, before being used in the business. Likewise the question as to how far the new clause in section 9 (which seeks to put foreign corporations on a par with domestic corporations) is constitutional, and just what is meant by the phrase "arising from the business done in this state," remains to be determined. But each of these problems involves too many considerations to be treated except at length.

J. Lindsey Heard.

NORFOLK, VIRGINIA.